

***“Flying by faulty instruments
is dangerous”***

(Walter B. Wriston, former chairman of Citibank)

***Can Non-financial Indicators Succeed where GAAP fails?
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Is this “The Moment of Truth”?

Will it go down in the history of business as a watershed date, a day of revolution?

- My material generated in an international six-year project
- aimed at creating a new reporting system
- recorded in a book, “The Baseline Revolution”.

Revolutions usually

- * start with an attack on the status quo
(“When in the course of human events...”)
- * are not nice and gentle
(The French Revolution)
- * hurt the established interests
(Gleick, in “Chaos”: “A new science often arises out of one that has reached a dead end.”)



More proof than we ever dreamt of

- * Criticizing a system backed by more than 500 years of tradition and legislation calls for plenty of courage, substance and proof.
- * Fortunately, the business community, business media and the accounting and auditing professions themselves have provided more proof than we ever dreamt of
- * We believed accounting was less than perfect. We did not imagine it was *that* bad.
- * Our criticism has been more and more vindicated
- * Contrary to what some people have taken for granted, the problems will not be solved by tighter rules, stricter supervision and small step-by-step modifications.

The failure is not GAAP’s, FASB’s or SEC’s. It is wider than that! Our conclusion:

*It is not enough to discuss
the rules of accounting
It is time to discuss
the role of accounting.*

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• Proofs from:

- the business community,
- business media,
- the accounting,
- auditing professions

• The problems will not be solved by

- tighter rules,
- stricter supervision,
- and small step-by-step modifications.

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*It is not enough to discuss
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It is time to discuss
the role of accounting.*

Fortunately, we are not alone:

Walter B. Wriston, Citibank, “The Twilight of Sovereignty”, 1992: *“Flying by faulty instruments is dangerous.”* and *“the old measures of economic progress and decay, success and failure, are rapidly losing their usefulness.”*

Bob Paterson, Can. Imp. Bank of Commerce, Fortune, Oct 1994: *“We asked ourselves why banks had become such crummy lenders. - - - Are we stupid? No, but we don’t know what we are lending against any more.”*

KPMG Chairman Steven Butler, Business Week, May 13, 2002: *“In our post-industrial economy, our accounting system doesn’t do a good job of describing any modern company.”*

Peter Drucker, “Managing in the Next Society”, 2002: *(We must) “change basic record-keeping to accommodate present economic reality - something accounting was never designed to do.”*

Henny Sender, the European Wall Street Journal, July 21, 2002: *“If corporate financial reporting appears to be built increasingly on sand, it is because in many cases it is.”*

From specialized tool to Swiss Army knife

- * a great tribute to Luca di Pacioli that his accounting system of 1494 still works - and works reasonably well - in the basic application: registering business transactions.
- * over the centuries, accounting and financial reporting have turned into a Swiss Army knife of the business community.

We submit that

Any use of accounting for other purposes than registering and summing up transactions can be dangerous, even fatal.

Some of the well known weaknesses in accounting, as we use it:

- Inherent focus on the past
 - yet sometimes it falls into the forecasting trap (trend extrapolation, “discounted cash flow”, “real options” etc.)
- Limited to financial information
 - yet sometimes it expands beyond it
- Its key documents, the Earnings Statement and the Balance Sheet, have proven to be either highly unreliable, or, at best, irrelevant
- Is unable, yet tries to, solve “the Value Mess”, the four distinctly different meanings of the crucial word “Value”
- Tried for a time to accommodate absurd “New Economy” measures (eyeballs etc.)
- Still tries to accommodate equally absurd traditional measures and ratios (P/BV, P/Equity, RoE, ROCE, P/E and others)

What damage? How serious?

Accounting-based data have come to be used for almost any function in business and the economy, creating clear and imminent dangers.

Examples of damages caused partly or entirely by reliance on accounting data:

- “Due Diligence” leading to disastrous M&A’s
- bank lending decisions on faulty parameters, leading to
 - (a) huge write-offs and other losses, and/or
 - (b) refusals, nipping off worthy projects
- financing decisions destroying millions in shareholder assets
- analyst advice leading to huge investor and retirement fund losses
- auditing and risk assessment processes looking in the wrong direction
- “Corporate Governance” issues, strategic choices and board agendas with misguided priorities
- blowing bubbles and spreading smoke screens - discrediting the business community

Yet, the indiscriminate use of accounting has been encouraged by fundamentalists in the accounting community.

The world has changed over 500 years

The need for better reporting systems has existed for a long time. Dramatic changes in today’s economy have intensified the need. Today we are in **the fourth economy**.
(*Not the rightly discredited “New Economy”!*)

We will discuss three major characteristics of **the fourth economy**:

1. Fast, unpredictable change as the norm, not an exception
2. Value generation primarily through “minds in interaction”, not through physical assets
3. Interdependence, not “the closed box”, as an essential feature of companies, the business community and the world

We need to develop “record-keeping to accommodate present economic reality - something accounting was never designed to do.”

1. Fast, unpredictable change

Basic Insight #1:

In a world of fast, unpredictable change, managers can not rely on extrapolations, prognoses and forecasts. Instead they must prioritize diagnoses and flexibility (“freedom of action”)

Percy Barnevik: *“Earlier, we could use the metaphor of sailing, when we discussed management. Today, management is more like whitewater kayak-rafting in class E rivers.”*

Colin Powell (when nominated for Secretary of State, NY Times, Dec. 17, 2000):
“Challenges and crises that we don’t know anything about right now will come along.”

Harry Potter: *“It sounds like fortune-telling to me, and Professor McGonagall says that’s a very imprecise branch of magic.”*

**Can “freedom of action” be defined and measured?
YES - but not through accounting!**

1. Fast, unpredictable change

Accounting-based methods fail in a time of fast, unpredictable change:

1. Trend extrapolation? NO! “Past performance is no guarantee for future results”

When accounting-based predictions meet reality: *“far surpassing analysts’ forecasts”*, *“XX Corp., instead of earning an expected half million dollars in the fourth quarter, said on Wednesday it lost about that amount in the period”*, *“beating Wall Street forecasts”*,

2. The ethics of “discounted cash flow” and other horoscopes

Technical sceptic Paul Kurtz, Amherst, NY, asked a large number of newspapers to disclaim their astrology columns. Most refused.

What would happen, if he made the same request to forecasting consultants?

3. A suggested disclaimer to be used by financial analysts and other “future sellers”:

“We accept that, unless we are equipped with divine powers, we can not predict the future.”

The way to handle the uncertainties of today’s world is to increase “freedom of action”.

Can “freedom of action” be defined and measured?

YES - but not through accounting data!

2. “Minds in interaction”

Basic Insight #2:

In a world where wealth is primarily created by “minds in interaction”, managers can not measure success or failure by material assets alone. Instead they must define and measure non-financial value drivers

1. Taiwan, with practically no natural resources, has done better than oil-rich Nigeria.
2. Two thirds or more of the US work force move and process ideas, not physical products.
3. Fourth economy companies have fared better on the stock exchanges than third economy companies, and third economy companies better than second economy companies.

**Can value drivers based on “minds in interaction” be defined and measured?
YES - but not through accounting!**

2. “Minds in interaction”

Accounting-based methods fail, when value is created by “minds in interaction”:

1. The Balance Sheet is more meaningless than it has ever been (Consequently P/BV, P/Eq, ROE, ROCE etc. are highly questionable)
2. “Valuation” based on BS data does not work
3. The demise of “financial analysis”
4. The intellectual disaster of “goodwill” calculation and depreciation

Do we think of “Intellectual capital”? - no!

IC was a good first step, but inherent weaknesses have made the concept outdated:

1. “Assets” do not create wealth - forces do. Value creation is a dynamic process
2. IC on the Balance Sheet? No! It would only make the BS even more confusing
3. More than intellectual - business depends also on emotional processes.

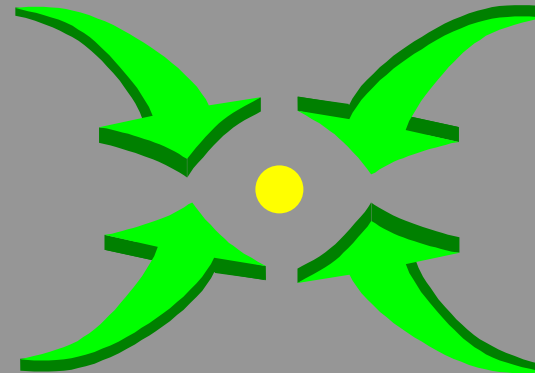
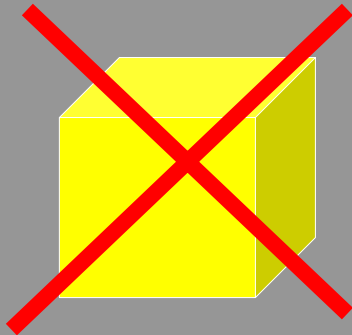
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3. Interdependence, networks - replacing “the closed box”

Basic Insight #3:

In a world where relationships are a condition for survival, managers can not limit their views and measurements to what happens within the company walls.

Instead they must define and measure the impact (positive and negative) of relationships, view the company in its context.



**Can interdependence, relationships, be defined and measured?
YES - but not through accounting!**

3. Interdependence, networks - replacing “the closed box”

The failure of accounting-based methods in a time of interdependence:

1. From vertical to virtual

“The virtual salmon company”

2. Accounting is inherently “autistic”

The fallacy of the legal accounting-supported view

3. Redefining the company, from “box” to network

Some companies - often the most successful ones - are “only” a network

4. From “Zero Sum” to “Win-win” - the expanding economic universe

Potential for unlimited growth - for the first time in world history

**Can interdependence, relationships, be defined and measured?
YES - but not through accounting!**

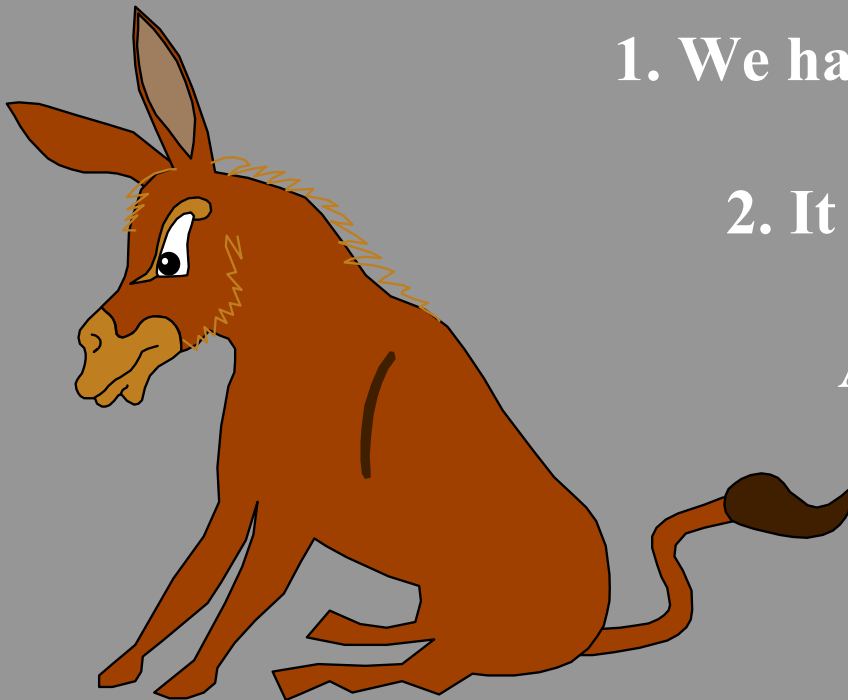
Why do we not already have an alternative reporting system?

Two possible reasons:

1. We have never done it before

2. It may be difficult

Are those reasons good enough
to keep and protect a
bad system?



“J'accuse”

We accuse the supporters of the accounting system of three offenses:

1. **Overextending** the applications of the accounting system beyond its legitimate use
2. **Preserving** a reporting system from the 15th century in a world that has changed drastically
3. **Neglecting** to develop a reporting system that can handle **three dominating parameters** of the fourth economy:
 - genuinely unpredictable *change as the norm*,
 - “*minds in interaction*” as the primary value driver
 - *interdependence* as an essential characteristic of companies, the business community and the world today

The World Needs a New Reporting System

It Can Be Done!

Today
may be the starting point!